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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

May 9, 1994

William Caton
Acting Secretary
Federal Communiations Commission
1919 M Street, NW
Room 222
Washington, DC 20554

**RE: Price Cap Performance Review for Local Exchange Carriers CC Docket No. 94-1**

Dear Mr. Caton:

Attached for filing are the Comments of the United States Telephone Association in the above-captioned docket. The comments exceed one hundred pages in length. Consequently, it was not possible to prepare an "accurate and clear condensation of the substance of the filing" as required by Rule 1.49(c) using only five pages. The summary of the comments is therefore ten pages long and, to the extent required, counsel hereby requests a waiver of the rule to accommate the summary.

Sincerely,

Mary McDermott

Mary McDermott
Vice President and
General Counsel

Attachments

**Before the**
**FEDERAL COMMUNICATIONS COMMISSION**
**Washington, D.C. 20554**

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| In the Matter of | ) | |
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| Price Cap Performance Review | ) | CC Docket No. 94-1 |
| for Local Exchange Carriers | ) | |

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**COMMENTS OF THE**
**<u>UNITED STATES TELEPHONE ASSOCIATION</u>**


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May 9, 1994

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## SUMMARY

### Introduction

This proceeding, which is one of the most important ever undertaken by the Commission, will consider whether and how the LEC price cap plan should be revised in order to meet the Commission's public interests goals during a period of rapid change in the telecommunications industry. USTA demonstrates that substantial revisions to the current price cap plan are needed in order to ensure the wide-spread availability of affordable telecommunications services, to promote the introduction of new services and technologies, to encourage the development of a National Information Infrastructure, to stimulate economic growth, to provide for balanced competition, to promote network efficiency, and to minimize regulatory burdens. Of particular importance, a revised price cap plan must provide strong and unequivocal investment and efficiency incentives by removing the last remnants of rate of return regulation, including earnings sharing and a rigid rate structure. A revised price cap plan must also afford LECs pricing flexibility in competitive access markets so that consumers can reap fully the benefits of price and service competition.

The current LEC price cap plan has produced more favorable results than would have been realized under full rate of return regulation over the past 3 1/2 years. The exist-

ing plan, however, can never reach the full potential of incentive regulation, let alone achieve the Commission's goals in the Information Age. This is so because the plan dulls LEC investment and efficiency incentives, and discourages innovation in the public network.

Unlike AT&T's price cap plan which has always resembled pure incentive regulation, and has moved closer to that ideal over time, the LEC plan has been closely tied to cost-based regulation from the start, most notably through the sharing mechanism, and has become increasingly restrictive as competition has entered LEC markets. Moreover, unlike AT&T, LEC new service offerings have had to conform to an antiquated rate structure, and have been made subject to an ever-changing set of regulatory hurdles.

The LEC price cap plan must be modified in order to reflect telecommunication's expanded role in the economy, and to provide the incentives necessary to develop an advanced telecommunications infrastructure. To achieve this, price caps must send correct market signals to all service providers whether they are LECs or new market entrants. Price caps must also permit LECs to respond fully to both customer needs and competition in access markets.

Further, a revised price cap plan must recognize and accommodate the momentous changes that are taking place in the telecommunications industry. Rapidly evolving and converging technologies are removing market barriers and are blurring the distinctions between once separate industry segments such as cable television and telephony. LEC access customers are increasingly demanding new service offerings, innovative features and flexible pricing arrangements.

Perhaps most important, competition is already substantial and can be expected to increase rapidly in many LEC access markets. CAPs serve access customers in most major metropolitan areas and in many secondary markets, and observers expect CAP revenues to triple by 1996. The growth of wireless services over the past decade has been nothing short of phenomenal. Wireless competition can be expected to increase at an even more rapid pace in the future with the introduction of PCS. Competition will also come from "out-of-region" LECs and electric utilities.

The presence and rapid growth of competition in many LEC access markets, together with revolutionary changes in technology and customer demand, require that the Commission adopt now a mechanism by which LECs in competitive markets can obtain relief from rigid pricing rules that were developed at a time when there was little or no access competition, when technology was relatively stable and when customer demand was far more predictable than it is today.

**USTA's Proposal**

The Commission must eliminate earnings sharing and the low-end adjustment mechanism. The elimination of sharing will provide incentives for achieving greater LEC efficiencies and for increased network investment. This, in turn, will spur economic growth. The elimination of sharing will also help to ease regulatory burdens by obviating the need for rate of return represcription and the affiliate transaction rules. It will also make possible meaningful depreciation reform.

The elimination of sharing will make it easier to remove services from price cap regulation as markets become more competitive. Further, by eliminating sharing and the low-end adjustment mechanism, the Commission will ensure that customers in less competitive markets will not be affected by changes in price or demand in more competitive markets, and that the risks of operating in an increasingly competitive environment will be borne by shareholders, not by ratepayers.

The Commission must also reform the access charge pricing rules which make it exceedingly difficult for price cap LECs to introduce new service offerings in a timely fashion, or to repackage existing services in response to changing customer needs. Currently, if a new service does not fit within the rigid Part 69 rate structure, a LEC must file for waiver or must petition to change the existing rules. The attendant delay in bringing new services to market merely adds to the disincentives for innovation built into the present price cap plan.

Only by eliminating the rate structure codification of Part 69, except for certain "Public Policy" rate elements, can the Commission ensure that rules do not delay or otherwise frustrate the introduction of new services. Without such action, LEC service introductions will continue to be subject to untenable delays and the Commission's goals of promoting innovation, network investment, and full and fair competition will be seriously impaired.

Decodification of Part 69 must be accompanied by increased LEC pricing flexibility as access markets become more competitive. This can be accomplished through a "market area" approach which would initially classify each of a LEC's current study areas or pricing zones as Initial Market Areas (IMAs). As a LEC's market power decreases in individual wire centers (or groups of wire centers) within an IMA, those wire centers would be reclassified as a Transitional Market Area (TMA) and would be subject to less regulatory scrutiny. Increasing competition within a TMA would allow the relevant wire centers to be reclassified as a Competitive Market Area (CMA) to which minimal regulation would apply.

In classifying wire centers as TMAs or CMAs, LEC market power would be measured based on the proportion of access demand in a market area that is "addressable" by alternative providers, *i.e.*, where LEC competitors have facilities that can provide service to a customer upon request. Unlike a market share measure, addressability is a forward-looking indicator of market power. This will help ensure that customers will receive the full benefits of competitive pricing and service offerings, and that market entry decisions will be based on realistic price signals.

For purposes of classifying a wire center(s) as a TMA, addressability would be shown by the existence of an operational expanded interconnection arrangement within the wire center, or by the offering of a substitutable access service by an alternative provider within the geographic area served by the wire center. TMAs, or parts thereof, may be reclassified as CMAs as each wire center satisfies additional criteria demonstrating increased competition.

Under USTA's proposal, the current price cap basket structure is replaced with revised baskets that allow the grouping of rates for equivalent functions. These baskets - Transport, Switching, Public Policy and Other - would facilitate pricing flexibility where warranted by competitive conditions, and would accommodate new services. Separate market area categories (*i.e.*, IMA or TMA) would be established within a basket (except the Public Policy basket which would have its own pricing rules specifically established for each rate element). Price changes within IMAs and TMAs would continue to be subject to price cap regulation, with increased pricing flexibility for the TMAs. Services within a CMA would be removed from price cap regulation.

With regard to new services, USTA's proposal provides for streamlined tariff support requirements and processing based on the degree of competition in a particular market area. This will allow for a more rapid, and less costly, introduction of new services in the most competitive markets while retaining substantial safeguards in less competitive markets. While still more restrictive than the rules applicable to CAPs and other LEC competitors, USTA's approach would further several important Commission goals, including promoting the introduction of new services and technologies, stimulating economic growth, and supporting universal service by ensuring the widest availability of new services among customers in the shortest possible time.

USTA submits that the only reason to adjust the price cap formula's productivity factor is to reflect changes in the long-term productivity of the LEC industry as a whole. Neither changes in interest rates, the recent past performance of the LEC, nor any other short-term phenomena, justify a change in the productivity factor.

USTA believes that the most appropriate and accurate way to determine LEC industry productivity is through a total factor productivity (TFP) study which utilizes direct and observable measures of industry inputs and outputs. USTA commissioned such a study which determined both the long-term historical productivity growth for the LEC industry, and the proper productivity offset in the price cap formula. This study demonstrates that the current productivity factor is unreasonably high, and that the Commission should adopt a new productivity factor that is no higher than 1.7%.

The Commission asks whether it should reconsider the use of the 50/50 formula for capping the Common Line basket. A common line adjustment formula is not necessary when the Commission determines the productivity offset based on a TFP analysis. Any common line adjustment formula would simply "double count" the growth in LEC output that is already reflected in the TFP study.

Further, the Commission should not limit exogenous cost treatment to economic cost changes as it proposes in the NPRM. Because telephone companies have historically been regulated based on accounting costs, changes in those costs can often have a real and substantial impact on LEC cost recovery which must be reflected in the relevant price cap indices.

USTA also urges the Commission to eliminate the non-economic bias against LEC networks that exists because AT&T is required to adjust its price cap indices only to reflect changes in what AT&T pays for access to LEC networks, but not for changes in prices it pays for access obtained from other sources. Moreover, increasing competition among LECs, CAPs and other access providers, requires equalization of the regulatory treatment of LECs and these other service providers.

There is no reason to increase service quality and infrastructure monitoring requirements that currently apply to the price cap LECs. Indeed, the Commission should reduce the existing reporting requirements as competition continues to develop in access markets. Nor should the Commission make any changes in the rules governing the sales and swaps of exchanges. Finally, the Commission should avoid diminishing LEC incentives by too-frequent review of the price cap plan.

**The Economic Impact of USTA's Proposal**

An analysis conducted by the WEFA Group shows that USTA's proposal would, if adopted, result in the growth of employment, gross domestic product and consumer benefits over and above that which would occur if USTA's recommendations were not implemented. Specifically, based on expected increases in telecommunications industry investment, and forecasts of both technological and quality enhancements to the public telecommunications network, WEFA projects that total real GDP will be increased by $60 billion by 2004 as a result of adoption of USTA's proposal.

This growth translates into tangible economic benefits over the ten-year forecast period. For example, automobile sales will increase by over 100,000 units and housing starts by almost 30,000 in 2004. Moreover, the economy will gain over 500,000 additional jobs.

Consumers, and not just telecommunications users, will also benefit from adoption of USTA's proposal. The annual inflation rates (as measured by the GDP deflator) will be 0.15 of a percentage point lower on average per year over the next ten years, 1.4% lower on a cumulative basis. By 2004, consumers will be saving approximately $130 billion in real terms on their total purchases, while their disposable income will be about $30 billion higher.

In sum, adoption of USTA's proposal will increase investment, encourage a more rapid deployment of new technology, and stimulate economic growth. These benefits will be enjoyed by virtually all segments of the U.S. economy.

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**COMMENTS OF**
**THE UNITED STATES TELEPHONE ASSOCIATION**

The United States Telephone Association (USTA) hereby comments on the issues raised by the Notice of Proposed Rulemaking (NPRM), FCC 94-10, released February 16, 1994, in the above-captioned proceeding.[1]

## I. INTRODUCTION - THE GOALS OF PRICE CAP REGULATION.

This proceeding will consider whether the Commission's price cap plan for local exchange carriers (LECs), which has been in effect since January 1, 1991, should be revised in order to meet the Commission's public interest objectives in future years.[2] To this end, the NPRM requests comment on whether the goals of price caps should be modified to reflect important changes in telecommunications technology and markets. The NPRM also seeks comment on a set of "baseline"

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[1] USTA is the principal trade association of the exchange carrier industry. Its membership of approximately 1,100 local telephone companies represents over 98% of telephone company-provided local access lines.

[2] NPRM, ¶ 4.

issues which look for ways of improving or adjusting the price cap plan. Finally, the NPRM raises several "transition" issues related to the changes that are rapidly transforming the LEC industry.

USTA strongly supports the Commission's decision to conduct a comprehensive review of the LEC price cap plan and to make revisions that are required to achieve important national policy goals. As discussed more fully in these comments, the telecommunications industry is currently undergoing a transformation of historic proportion. New technologies are making possible services that were unheard of only a few years ago. Previously separate telecommunications media are rapidly being reduced to a common digital stream, controlled by microprocessors and transported over virtually unlimited-capacity fiber optic facilities or the tetherless airwaves.

Additionally, customers are becoming increasingly sophisticated and are demanding advanced features and functions, complex service configurations and innovative pricing arrangements. New service providers are proliferating, and diverse industry participants are entering into strategic relationships in recognition of the convergence of technologies and the confluence of what once were separate telecommunications markets. Each of these changes demands flexible regulatory policies that will help all citizens reap the benefits of the new Information Age. Because of the LECs' important role in the telecommunications industry, and because price caps have a substantial impact on LEC incentives and performance, the Commission's review could not have come at a more opportune time.

USTA also agrees with the Commission that the price cap plan's original, but limited, objectives must be expanded if the full potential of the telecommunications revolution is to be achieved in terms of stimulating economic growth, developing a National Information Infrastructure, and promoting universal service to all geographic areas and demographic groups.[3] In this regard, USTA recommends the following expanded set of goals for a revised LEC price cap plan to help guide the Commission in this proceeding:[4]

A LEC price cap plan should -

(1) **Help Promote Universal Service** by encouraging the wide-spread availability of telecommunications services at affordable prices.[5]

(2) **Promote the Introduction of New Services and Technologies** by removing existing obstacles in the regulatory process.

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[3] See NPRM, ¶¶ 33, 34; General Issue 1.

[4] These include the goals of the existing price cap plan plus additional objectives as discussed more fully in Section II below.

[5] USTA notes that while a price cap plan can facilitate the attainment of universal service objectives, other important factors, such as funding of interstate support mechanisms by all market participants, must also play a role.

(3) **Encourage the Development of a National Information Infrastructure** by providing proper incentives and flexibility for LECs to make the large capital investments that will be required.

(4) **Stimulate Economic Growth** by helping to reduce costs of production and inducing customers to make greater use of telecommunications services.

(5) **Allow for Balanced Competition in Access Markets** by recognizing the rapid market changes that are taking place in the LEC industry.

(6) **Promote the Efficient Use of the Network** by ensuring that decisions made by all carriers and their customers approximate decisions made under competitive market conditions.

(7) **Prohibit Unreasonable Discrimination**, but provide the necessary pricing flexibility that would allow reasonable price differentiation based on market conditions.

(8) **Minimize Regulatory Burdens** by removing unnecessary rules and restrictions that no longer serve an essential public interest purpose.

USTA believes that these goals can be fully achieved only by a price cap plan that: (1) provides strong and clear investment, efficiency and innovation incentives to LECs by removing the last vestiges of rate of return regulation from the plan, including earnings sharing and a rigid rate structure; (2) affords pricing flexibility that recognizes the changes which are transforming many LEC markets; (3) incorporates plan features that will not impede continuing LEC investment and innovation; and (4) alleviates burdensome regulatory requirements, and promotes regulatory parity between LECs and their competitors. The details of such a plan are set forth in Section IV below.[6]

The remaining sections of these comments demonstrate that the plan revisions proposed by USTA will meet the Commission's objectives and will otherwise serve the public interest. In particular, Section II shows that while the existing price cap plan has yielded public interest benefits, substantial changes are needed if the plan is to achieve the Commission's goals in the future. Section III demonstrates that since the plan was adopted nearly four years ago, there have been important changes in telecommunications technology and markets which must be recognized and accommodated by a revised LEC price cap plan.

Section IV sets forth USTA's recommendations for reform of the Commission's rules governing price cap carriers. USTA strongly believes that adoption of its proposal - in particular, the complete elimination from price caps of rate of return regulation, rate structure reform and increased pricing flexibility - is crucial to the future success of

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[6] Some of USTA's recommendations were proposed in USTA's Petition for Rulemaking, filed September 17, 1993, in RM-8356, Reform of the Interstate Access Charge Rules (USTA Petition). The instant NPRM recognizes that any decision that the Commission makes regarding changes to the price cap plan "must be consistent with decisions made in other proceedings," including the proceeding on USTA's Petition. (NPRM, ¶ 91) The Commission requests comment on how it "can best harmonize the review of LEC price caps" with other proposals such as USTA's access reform proposal. (Id.) USTA provides such comment below.

price caps and to ensuring that all interstate access users reap the benefits of competition.

Section V of these comments summarizes economic studies which demonstrate that USTA's proposal will achieve important Commission objectives. Section VI describes how the issues raised in this proceeding can be best harmonized with other pending Commission proceedings and proposals.[7]

Finally, parts of USTA's comments, and virtually all of its proposal, are supported by the studies and reports of several noted economists in the telecommunications field. An Executive Summary of these reports is appended to these comments as Attachment 1. The most comprehensive of the reports, "Economic Benefits of LEC Price Cap Reform" by Professor Robert G. Harris, is appended hereto as Attachment 2.[8]

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[7] Except as specifically noted herein, these comments are not intended to affect the Commission's regulation of LECs that remain subject to rate of return regulation which is an appropriate form of regulation for many smaller telephone companies. These comments also do not propose any changes in the optional incentive regulation plan recently adopted by the Commission for small and mid-sized local exchange carriers. See Regulatory Reform for Local Exchange Carriers Subject to Rate of Return Regulation, 8 FCC Rcd 4545 (1993).

[8] The other reports include "Price Cap Reform, Financial Incentives and Exchange Carrier Investment," by Larry A. Darby (Darby), appended hereto as Attachment 3; "Comments on the USTA Pricing Flexibility Proposal," by Richard Schmalensee and William Taylor (Schmalensee and Taylor), appended hereto as Attachment 4; "Economic Performance of the LEC Price Cap Plan," by National Economic Research Associates, Inc. (NERA), appended hereto as Attachment 5; "Productivity of the Local Telephone Operating
(continued...)

Professor Harris is on the faculty of the Haas School of Business, University of California - Berkeley, and is a principal of the Law and Economics Consulting Group, Inc. Together with the other economists commissioned by USTA, Professor Harris demonstrates that USTA's proposal is economically sound and will further the Commission's public interest objectives.

## II. LECs HAVE PERFORMED WELL UNDER THE CURRENT PRICE CAP PLAN, BUT FUNDAMENTAL CHANGES ARE NEEDED IF THE PLAN IS TO MEET THE COMMISSION'S OBJECTIVES THROUGH THE 1990'S AND BEYOND.

### A. The LEC Price Cap Plan - From Concept to Reality.

The concept behind incentive regulation in general, and price caps in particular, is simple. The Commission has recognized that the "attractiveness of incentive regulation lies in its ability to replicate more accurately than rate of return the dynamic, consumer-oriented process that characterizes a competitive market."[9] Incentive regulation

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[8](...continued) Companies Subject to Price Cap Regulation," by Lauritis R. Christensen, Philip E. Schoech, and Mark E. Meitzen (Christensen), appended hereto as Attachment 6; "The Economic Impact of Revising the Interstate Price Cap Formula for the Local Exchange Companies," by the WEFA Group (WEFA), appended hereto as Attachment 7; and "Accelerating Investment in the Telecommunications Network - Impacts on Technology Adoption and Service Quality," by Lawrence K. Vanston (Vanston), appended hereto as Attachment 8.

[9] Policy and Rules Concerning Rates for Dominant Carriers, Report and Order and Second Further Notice of Proposed Rulemaking, CC Docket No. 87-313, 4 FCC Rcd 2873, ¶ 36 (1989).

"operates by placing limits on the rates carriers may charge for services."[10] Faced with such constraints, "a carrier's primary means of increasing earnings are to enhance its efficiency and innovate in the provision of service."[11] In short, price cap regulation promises many of the benefits expected from a competitive market without the complicated, and often arbitrary, cost allocations and inefficient pricing distortions that are characteristic of traditional rate of return regulation.

While conceptually simple, the current LEC price caps is far from a simple plan. "The plan is a fairly complicated approach to regulation consisting of baskets of services, formulas for rate changes, exogenous and endogenous factors, sharing arrangements, and earnings ceilings."[12] These plan features, which were ostensibly adopted for public interest reasons, often undermine the very foundations of incentive regulation.

For example, the price cap sharing mechanism was adopted because the Commission perceived a difficulty in "determin[ing] a single, industry-wide productivity offset

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[10] Id.

[11] Id.

[12] "Beyond Price Caps: Escaping the Traditional Regulatory Framework," speech by Commissioner Andrew C. Barrett to The Florida Economic Club, August 27, 1992, p. 1 (Barrett Speech).

that will be perfectly accurate for the industry as a whole or for individual LECs or market conditions at a given time."[13] Whether the profit sharing mechanism has served its purpose is less than clear. What is clear, however, is that sharing has substantially dulled the efficiency incentives of the price cap plan. A recent study estimates that a 4-year hybrid price regulation plan with 50/50 sharing (essentially, the Commission's plan) has only about 18 percent of the efficiency incentives provided in an unregulated competitive market - not much more than the incentives (14%) provided by rate of return regulation over a one-year period.[14]

Additionally, the LEC price cap plan has become even more complex and restrictive since it was adopted only 3 1/2 years ago. This is particularly true with respect to the introduction and pricing of new services.[15] As a result, regulatory requirements often delay the introduction of new services by LECs for months, subjecting new service offer-

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[13] Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, CC Docket No. 87-313, 5 FCC Rcd 6786, 6801 (1990).

[14] See "Regulatory Reform for the Information Age," prepared by Strategic Policy Research, Bethesda, MD, pp. 22-23 (January 1994) (SPR Report).

[15] See, e.g., Amendment of Part 69 of the Commission's Rules Relating to the Creation of Access Charge Subelements for Open Network Architecture, 6 FCC Rcd 4524 (1991) (Part 69/ONA Order), on recon., 7 FCC Rcd 5235 (1992) (Part 69/ONA Recon Order).